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memorandum**

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subject: The effect of a cash settlement on the deductibility of issuance costs for a forward contract on the issuer's own stock

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Date1 =

Date2 =

Date3 =

Date4 =

TY1 =

TY2 =

w# =

x# =

y =

z =

\$m =

\$n =

\$N =

\$o =

\$p =

\$q =

\$r =

\$s =

ISSUE

Does the section 1032(a) ruling in PLR 200450016 (“the PLR”) (supplemented by PLR 200518062), which addresses the cash settlement¹ of a forward contract on Taxpayer’s own stock, support Taxpayer’s position that stock issuance costs may be deducted as a loss under section 165 because Taxpayer asserts that it did not issue stock pursuant to the forward contract?

¹ The use of the phrase “cash settlement” in this CCA is discussed in section B. of LAW AND ANALYSIS.

CONCLUSIONS

The PLR does not support Taxpayer's position. First, the ruling addresses the application of section 1032(a) to gain realized by Taxpayer for money received to settle a forward contract involving its own stock. Issuance costs were not mentioned in the PLR nor did taxpayer raise these costs in its request for the PLR. Second, in the PLR, section 1032(a) applied to the transaction because the cash settlement of a forward was treated as if Taxpayer issued its stock to complete the forward. Third, the PLR determined that there was a gain on the forward; any costs attributable to the forward would have to be netted against any gain on the forward to determine overall gain or loss. Fourth, a section 165 loss can be taken for a loss incurred in a transaction that is later abandoned. Here, Taxpayer did not abandon the forward contract. Taxpayer received cash on the forward, and, including the issuance costs, there was an overall gain.

FACTS FROM PLR 200450016

The Investment Units

In TY1, Taxpayer issued w# investment units (Units) to investors. Each Unit had an issue price of \$n and consisted of a Forward Contract on Taxpayer's own stock and a Note issued by Taxpayer. The issue price of \$n was allocated entirely to the Note.

Under the Forward Contract, Taxpayer would deliver on the maturity date one share of its common stock in exchange for each investor's payment of \$n (the Forward Price). Investors received a quarterly fee of y percent of the Unit's value. Investors could settle the Forward Contract in cash prior to the maturity date. The Forward Contract's maturity date was Date1.

Under the Note, Taxpayer paid each investor z percent interest on the \$n principal Note. Before the Note was due, Taxpayer was required to try to remarket (resell) the Note on behalf of each investor. The first attempt was due on Date2, and required Taxpayer to remarket the Note for a price that would pay the \$n Forward Price. If this attempt failed, Taxpayer would have to attempt a second remarketing on Date3. If the second attempt failed to yield the appropriate proceeds, each investor was able to deliver the Note as payment under the Forward Contract. The Note was due Date4.

Rulings and Exchange Offer

By TY2, Taxpayer's stock value had decreased to \$o (the numbers have been simplified throughout this discussion) and its credit rating had declined. This made it difficult for Taxpayer to remarket the Notes. Taxpayer wanted to satisfy its obligations under the Units before the first remarketing was due. In addition, Taxpayer was in a gain position on the Forward Contracts (because Taxpayer's stock value was less than the Forward Price), and the investors were in a loss position. To induce the investors to complete the Forward Contracts before the remarketing was due, Taxpayer made the offer to the investors to reduce the Forward Price to \$N instead of the original Forward

Price of \$n, and complete the Forward Contracts with cash. Reducing the Forward Price had the effect of decreasing by a small portion the loss the investors would realize on the Forward Contracts. The submission Taxpayer submitted in its ruling request provided the approximate amounts that the investors would pay Taxpayer to “cash settle” the Forward Contracts.

ISSUANCE OF PLR 200518062

After receiving its ruling letter, Taxpayer requested a supplemental PLR to update the final numbers and values from the Exchange Offer. The supplemental request did not seek a ruling on the possibility of deducting the issuance costs at issue here. The supplemental PLR, as with the initial PLR, contained the standard no opinion language. The supplemental PLR also made no opinion about “effects resulting from, the proposed transaction that are not specifically covered by the above ruling or those rulings set forth in the Prior Letter Ruling.”

THE CURRENT DISPUTE

The Service and the Taxpayer agree that there were issuance costs allocable to the Forward Contract portions of the Units. The dispute is about whether the issuance costs allocated to the Forward Contract portions of the Units are deductible as losses under section 165. Taxpayer asserts that the costs are deductible because they were incurred for a transaction that was abandoned. On its TY2 tax return that included the year the Exchange Offer was completed, Taxpayer allocated all of its capitalized issuance costs to the Note portion of the Units. Since its original return, TP agreed with Exam to allocate \$r of its total capitalized issuance costs to the Forward Contract portions of the Units. Of the \$r allocated to the Forward Contracts, Taxpayer now claims a \$s loss deduction. This deduction is for a loss Taxpayer claims it sustained with respect to the Forward Contracts.

The Service asserts that the issuance costs offset the amount realized from the completion of the Forward Contracts. Exam takes the position that issuance costs are not deductible because they offset the proceeds received from the permanent capital raised. See *McCrary v. U.S.*, 651 F.2d 828(2d Cir. 1981); *Barbour Coal Co. v. Comm’r*, 74 F.2d 163 (10th Cir. 1934); *Affiliated Capital Corp. v. Comm’r*, 88 T.C. 1157 (1987).

Taxpayer claims that based on the cash settlement analysis in PLR 200450016 the \$s in issuance costs allocated to the Forward Contracts can be deducted in TY2 as a loss. Taxpayer argues that such issuance costs are allowed under section 165 because the issuance costs were incurred to facilitate a stock issuance pursuant to the Forward Contracts, whereas no stock was actually issued pursuant to the Forward Contracts. It asserts that the cash settlement analysis does not allow Taxpayer to issue its stock under the Forward Contracts. As we understand the Taxpayer’s argument, the issuance costs incurred to facilitate a stock issuance under the Forward Contracts became a loss when the Forward Contracts were purportedly abandoned. The cash

paid by the investors, the argument continues, was paid pursuant to the Exchange Offer, which was a separate new contract.

You asked us whether the section 1032(a) ruling supports Taxpayer's position that the issuance costs allocated to the Forward Contracts can be deducted in TY2 because Taxpayer did not issue stock under the Forward Contracts.

LAW AND ANALYSIS

A. PLR 200450018

Revenue Procedure 2004-1, 2004-1 C.B. 1, governed Taxpayer's 2004 ruling requests. Pursuant to the Rev. Proc., Taxpayer submitted a proposed transaction, and based on the form of the transaction chosen by Taxpayer, the Service ruled on the tax consequences of the transaction that was presented. Thus, Taxpayer chose the form of its transaction that was addressed in PLR 200450018. Taxpayer stated in its letter requesting an appeal from the examining agent's determination, that the National Office set forth the substance of the transaction as a cancellation of the Forward Contracts for cash. However, this is Taxpayer's characterization. The National Office issued the following ruling: "Company will be paid \$i by each accepting Unit holder in settlement of each Contract. This amount is gain resulting from Company's receipt of property in cash settlement of its [Forward] contract to sell its stock . . ." (Emphasis added.)

Taxpayer did not raise or discuss issuance costs in its PLR submission or request a ruling on these costs. Moreover, none of the rulings Taxpayer received in the PLR address the deductibility of the issuance costs. The rulings focused on the application of section 1032(a) to the amounts received by Taxpayer in cash settlement of its Forward Contracts. We note that the ruling letter also did not contain the background analysis the Service considered in reaching its decision to rule favorably on Taxpayer's ruling requests. However, because this analysis is pertinent to the issue that has arisen over Taxpayer's issuance costs undertaken pursuant to the Forward Contracts, we set forth our analysis below.

B. Why did the Service apply section 1032(a) to Taxpayer's gain on the Forward Contracts when no stock was issued?

The Service views the physical settlement and the cash settlement of a forward contract as economically the same transaction. Section 1032(a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Thus, when a corporation is in a gain position on a forward contract on its own stock and issues stock to the counterparty in exchange for a payment ("physical settlement"), section 1032(a) nonrecognition applies to any gain (or loss) from the amount realized from the payment for such stock. When a corporation is in a gain position on a forward contract on its own stock, and it does not issue stock because the parties agree to "cash settle", the

corporation receives a payment from the counterparty, in the amount that represents the difference between the forward contract price and the value of the shares of stock on the date of the cash settlement. Section 1032 nonrecognition also applies to the payment the corporation receives in the cash settlement. The net amount by which the corporation is ahead is the same whether it issues the stock for the payment or receives a cash settlement in lieu of issuing stock. In effect, in a cash settlement, the corporation is deemed to issue its stock at the forward contract price, and immediately buy it back from the counterparty at the fair market value.

In the instant case, Taxpayer sought a section 1032(a) ruling because it was in the gain position on the Forward Contracts and it proposed a cash settlement of its Forward Contracts. Taxpayer was in a gain position because, in a physical settlement, Taxpayer would have issued one share of stock worth \$o in exchange for a \$n payment, resulting in a \$p gain realized. In a cash settlement, investors would make a \$p payment to Taxpayer, which would reflect the \$n payment owed less the value of Taxpayer's stock. The completion of the Forward Contracts by Taxpayer and the investors, whether by physical settlement or cash settlement, resulted in Taxpayer realizing the same amount of gain. The Service did not perceive a reason to suggest that Taxpayer change the form of its transaction and issue a share of stock for the section 1032(a) ruling, since the tax consequences under section 1032 were the same whether Taxpayer physically settled or cash settled the Forward Contracts.

The Service's policy that both a physical settlement and a cash settlement of a forward contract on the taxpayer's own stock should be treated as a transaction to which section 1032 applies is based on the notion that the two transactions are economically the same, and that to treat section 1032 as applying to a physical settlement but not to a cash settlement would create an opportunity to whipsaw the Service. If the Service did not apply section 1032 to a cash settlement of a stock sale agreement, including forward contracts, Taxpayers in a gain position would always physically settle to get nonrecognition under section 1032, and taxpayers in a loss position would always cash settle to get out of section 1032 and recognize the loss.

The Taxpayer's position in the instant case creates a third characterization of the transaction and one which, if adopted, would create yet another opportunity for whipsaw. Taxpayer received a net payment from a cash settlement on the Forward Contracts and realized gain. The Service ruled the gain realized was not recognized because section 1032(a) applied. However, Taxpayer now claims that the cash settlement of the Forward Contracts, pursuant to its Exchange Offer, was a different contract from the Forward Contracts which the Exchange Offer was settling. It claims that the Forward Contracts were thus "abandoned", and the payments from the investors were received pursuant to the Exchange Offer instead, resulting in a loss deduction under section 165 for costs allocated to the Forward Contracts.

However, had the Taxpayer presented as the facts in its PLR submission that it received the settlement proceeds for some transaction other than the contract to sell its

own stock, i.e. the Forward Contracts, section 1032(a) would not have applied to the gain. The Service issued the section 1032 ruling in the PLR because it treated the cash settlement proceeds as payment for Taxpayer's stock under the Forward Contracts. Taxpayer's tax treatment of its costs is inconsistent with its tax treatment of the proceeds received under the cash settlement. Taxpayer's position would require the Service to allow a loss on the same Forward Contracts that produced gain. That position is internally inconsistent and is not the position of the Service.²

C. Taxpayer's claimed section 165 loss deduction for costs under the Forwards should be disallowed because Taxpayer did not abandon the Forwards.

Taxpayer's position is that the Forward Contracts were abandoned to pursue the Exchange Offer. Taxpayer relies on the fact that the Service issued a ruling accepting the cash settlement form of the analysis in PLR 200450016 to support its position that it abandoned the Forward Contracts because under the cash settlement form it did not physically issue stock as originally contemplated under the Forward Contracts. Instead, Taxpayer's argument continues, it pursued the Exchange Offer, a different contract, which allowed it to settle the obligations under the Forward Contracts.

The Service's position is that the Taxpayer did not abandon the Forward Contracts and in fact completed the Forward Contracts via cash settling those contracts. The Forward Contracts were profitable to Taxpayer and indeed the gains realized by Taxpayer were the result of the investors' obligations to Taxpayer under the Forward Contracts. Taxpayer was paid \$ per forward obligation in a cash settlement of the Forward Contracts. The payments Taxpayer received to settle the Forward Contracts were a payment of the investors' obligations under the Forward Contracts, even though some of the terms were modified in a document Taxpayer labeled "Exchange Offer."

Despite the modified terms, Taxpayer received payments based on the same subject matter (stock), the same counterparties (the investors), and the same referenced Forward Price. Therefore, Taxpayer received the \$ payments pursuant to the Forward Contracts.

Section 165 allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Deductions for abandonment losses are provided for in § 1.165-2(a), which provides a loss is deductible under § 165(a) if it is incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued

² Although not controlling, the same dilemma could exist when costs are paid to acquire bonds that pay out tax-exempt income. In such cases, however, the dilemma is resolved by section 265(a), which disallows a deduction for any amount otherwise allowable that is allocable to income (other than interest) wholly exempt from the taxes, or any amount otherwise allowable under section 212 which is allocable to interest wholly exempt from the taxes imposed by subtitle A.

or where such property is permanently discarded from use therein. Accordingly, a loss is deductible only where the taxpayer has actually entered into a transaction for profit and the transaction is abandoned. Rev. Rul. 57-418, 1957-2 C.B. 143. Moreover, under § 1.165-2(b), the provisions for abandonment losses do not apply to losses sustained on the sale or exchange of property.

Changes in a transaction do not constitute abandonment. For example, in *FRGC Investment, LLC v. Comm'r*, T.C. Memo. 2002-276 (October 31, 2002), the taxpayer, in 1995, entered into a real estate contract to purchase 240 acres for development from an entity owned by individual. After objections to surveys and other title reports, the escrow for the contract was cancelled. In 1996, taxpayer entered into a second real estate contract with the same entity to purchase 404 acres of the same land for development. Approval for zoning the development became unlikely so, in 1997, the taxpayer and entity executed mutual cancellations of the contract to release the escrow. In 1998, taxpayer and the individual owning the entity that was a party to the first two contracts decided to execute a third contract. The contract was fulfilled and the escrow closed that same year, resulting in taxpayer owning the land that it sought to develop. Taxpayer claimed a section 165 loss for expenses incurred in 1997 arguing the 1997 contract had been abandoned. The tax court disagreed. It found that taxpayer's claims that the 1998 contract was different from the purported abandoned 1997 contract was rebutted by the fact that taxpayer moved forward to purchase the same real estate for the same purpose, although there had been changes in the terms of the agreement. Furthermore, the tax court was unwilling to ignore the fact that the contract to purchase real estate that was allegedly abandoned in fact resulted in the taxpayer owning the real estate for development. In the end, the tax court determined that the 1996 contract was not abandoned in 1997 but was merely a step in taxpayer's attempts to complete the transaction aimed at acquiring and developing the land it eventually acquired.

In the instant case, Taxpayer claims the changes in the method of completing the Forward Contracts resulted in an abandonment of the Forward Contracts in favor of the Exchange Offer. The changes do not rise to the level of abandonment of Taxpayer's Forward Contracts. Moreover, the transaction culminated in a sale or exchange of property, a disposition for which the abandonment loss provisions are not applicable.

A loss deduction is allowed for costs incurred for a transaction when the taxpayer is left without any value to show for the costs incurred. In Rev. Rul. 79-2, 1979-1 C.B. 98, individual taxpayers were allowed a section 165(c) loss when they abandoned a public offering of their corporation. The shareholders of M Corporation decided to make a public offering of some of their combined holdings. During the months prior to the offering, legal, accounting, registration, and printing fees were paid by the individual shareholders to make the offering. The offering was postponed due to unfavorable market conditions and then the shareholders stopped their plan to publicly sell their stock. The Ruling reasoned that a section 165(c) loss was appropriate because the public offering became worthless when it was abandoned. In Rev. Rul. 77-254, 1977-2 C.B. 63, the taxpayer, after investigating several businesses to purchase, eventually

decided to purchase a specific business and incurred expenses in an attempt to purchase this business. Certain disagreements between the individual and the owner of the business developed and the individual abandoned all attempts to acquire the business. The Ruling reasoned that costs otherwise capitalized became a loss when the transaction failed. In the Ruling, Taxpayer never acquired the business and the costs of that transaction became deductible.

In this case, Taxpayer was not left without value to show for the costs it allocated to the Forward Contracts. Taxpayer was left with cash. In fact, Taxpayer received the same value under the Exchange Offer as it would have under the Forward Contracts (as adjusted by the amount of the inducement to the investors to settle the Forward Contracts early). Taxpayer received \$p on each of the x# of the Forward Contracts returned in the Exchange Offer. The Exchange Offer was the same transaction as the Forward Contracts: Taxpayer was entitled to payment from the investors under each contract for the same obligation – i.e. the investor's obligation under the Forward Contracts to purchase a share of stock. An investor who entered into one Unit with Taxpayer, had an obligation to buy one share of stock at \$n. The investor could have paid \$n for a \$o share under the Forward Contract, which would have resulted in a net value to Taxpayer of \$p. Pursuant to the Exchange Offer, investors paid Taxpayer \$p, which became the net result to the Taxpayer. The Exchange Offer merely continued the transaction started in the Forward Contracts and because the Taxpayer did not abandon the Exchange Offer but received cash under the transaction, a sale or exchange occurred and no abandonment loss is appropriate.

D. Taxpayer's argument that the Example under Section 1.263(a)-5 of the regulations supports its position is erroneous.

Taxpayer stated in its appeal letter: "Since the Forward Contracts were settled by the payment of cash to [Taxpayer] and not by the issuance of stock by [Taxpayer], [Taxpayer] deducted the ...issuance costs allocable to the Forward Contracts under section 165." Taxpayer cited to §1.263(a)-5(l), Example 3, in the regulations.

Section 1.263(a)-5(a) provides that a taxpayer must capitalize an amount paid to facilitate an applicable transaction. An applicable transaction includes an acquisition of capital or a stock issuance. §1.263(a)-5(a)(7), (8). Example 3 of § 1.263(a)-5(l) provides facts specifying that a taxpayer incurs costs to evaluate four alternative transactions and abandons three of the four transactions. The Example concludes that the taxpayer may recover under section 165 amounts to facilitate the three abandoned transactions when such transactions are abandoned.

In citing to Example 3, Taxpayer's point seems to be that the Forward Contracts were an abandoned transaction and the Exchange Offer was not, and, thus, the costs incurred on the Forward Contract are deductible as a section 165 loss.

However, in the instant case, this Example is not applicable. First, section 263, by its terms, is not relevant in determining whether a taxpayer has abandoned an asset. Specifically, a taxpayer must apply the regulations and precedents under section 165 to determine whether an abandonment has occurred and whether the taxpayer is entitled to an abandonment loss.

Second, Example 3 is factually distinguishable from, and has no relevance to Taxpayer's situation because Taxpayer's facts do not involve separate and distinct transactions, and do not involve an abandoned transaction. The facts in Example 3 present four different possible transactions, between a taxpayer and four different parties. In our case, there is only one transaction, and one set of parties... Taxpayer began with Units that consisted of a Forward Contract and a Note, and Taxpayer was paid under the Forward Contract through a cash settlement, and it paid back the Note with cash and stock. The Forward Contract was completed and not abandoned. Merely because Taxpayer labeled the settlement of the Forward Contract as an "Exchange Offer" in its dealings with the investors, does not have the effect of abandoning the Forward Contract. The Forward Contract contained the obligations that were the subject of the Exchange Offer. The investors were in a significant loss position under the Forwards. The price the investors ultimately paid Taxpayer was based on the obligations of the investors under the Forward Contracts. The Exchange Offer did not release the investors from their obligations under the Forward Contracts. The Exchange Offer provided the investors an inducement, by adjusting the Forward price slightly downward, to settle the Forward Contracts prior to their maturity. Thus, the Taxpayer's facts do not involve the abandonment of a transaction under section 165.

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